

CHAPTER 1

EXECUTIVE SUMMARY / FINDINGS AND RECOMMENDATIONS PROJECT OVERVIEW ACKNOWLEDGEMENTS

Chapter 1 includes the Executive Summary and a series of key Findings and Recommendations. Both the Executive Summary and the Findings and Recommendations are linked to more detailed references in the subsequent Chapters and in the Appendices.

The Project Overview details the scope of work requested by the Washington State Gambling Commission for this project, and acknowledgements of key WSGC staff and colleagues.

CHARITABLE AND NONPROFIT GAMBLING IN THE STATE OF WASHINGTON
A RESEARCH PROJECT PREPARED FOR
THE WASHINGTON STATE GAMBLING COMMISSION
July, 2004

EXECUTIVE SUMMARY

Charitable and nonprofit (C/NP) gambling was always included in legislative discussions regarding the authorizing of gambling in Washington State. For some legislators, it was the primary reason to authorize gambling. However the legislative history indicates clearly that the Legislature intended that their authorization of gambling should be broader than charitable and nonprofit activities. Further, the Legislature did not single out charitable and nonprofit gambling for special priority or treatment. See Appendix A for a detailed history of gambling in Washington State and Appendix B for an analysis of the relevant legislative declarations.

Today, the charitable/nonprofit gambling sector in Washington State is declining. Bingo gross receipts in particular have declined steadily over the past nine years. Gross receipts for charitable/nonprofit punchboards/pulltabs (PB/PT) have also declined, but more slowly, such that PB/PT gross receipts were nearly as high as Bingo by 2003.

For calendar year (CY) 2003, PB/PT net income exceeded Bingo net income, and Raffles earned almost half as much net income as Bingo did. See Chapters 2 and 3 for details of these trends.

The Commission has been very successful and effective in its regulation of how charitable/nonprofit gambling activities and games are operated. While there have been some compliance issues, in general the licensees have operated successfully within the rules. Chapter 4 provides an overview of the Commission's regulatory efforts.

The one exception to this has been the net income/net return/adjusted cash flow issue. Since 1983 the largest licensees have struggled to comply with the rules and have sought assistance from the Commission numerous times. The Commission has made nine rule changes in this area since 1983. However the changes made since 1990 have reduced the required cash flow for the largest licensees by 58%, a dramatic and probably unintended result. See Chapter 6 for more detail.

The goal of assuring a portion of the gambling proceeds are applied to the stated purpose common throughout C/NP gambling in the United States; the question is whether the net income/net return/adjusted cash flow method is still sufficient to achieve the goal. A number of other states focus on regulating expenses, either by amount or type of expense. See Other States, Chapter 7.

The Commission is urged to step back and discuss its overall philosophy and approach to regulating charitable/nonprofit gambling, so that Commissioners and staff are using agreed-upon principles and standards to develop and modify rules, and respond to licensee concerns. Both Chapter 4 and Appendices F and G provide additional information.

Within that philosophy and approach, the Commission should re-examine standards related to adjusted cash flow or net income requirements and verification of primary purpose other than gambling to be sure that the requirements adequately carry out the Commission's desired regulatory approach. See Chapter 6 and Appendices F and G for further detail.

In addition there are a number of fundraising, financial and governance standards widely used in the broader charitable/nonprofit environment that the Commission might consider applying in its work. See Chapter 4 and Appendix G.

Finally, the Commission is urged to make greater use of its extensive database to analyze trends and flag emerging problems in the charitable/nonprofit sector. Appendices F and C provide some examples.

Competition from Indian gambling and commercial gambling within Washington State and neighboring states and Canada has increased greatly. There have been significant changes in the market for charitable nonprofit gambling. This may mean that the business model for charitable/nonprofit gambling, especially Bingo, no longer works well.

Bill Virgin, business columnist for the Seattle Post-Intelligencer, discusses gambling in his July 13, 2004 column. He notes the impact of gambling expansion: "The net effect in gambling will be what happens in any industry when the rare becomes commonplace—it becomes a low-margin commodity business."

Applying that concept specifically to charitable/nonprofit gambling, it is likely that the margins (net income) generated by C/NP gambling will continue to decline. It will become increasingly difficult to attract new players and retain existing players.

The one "competitive advantage" that charitable and nonprofit gambling has (and will have) to offer players is the opportunity to benefit a good cause. This is C/NP gambling's niche, its unique position. However, taking greater advantage of this niche will require the Commission and C/NP gambling licensees to pay more attention to the charitable/nonprofit aspect of the industry.

It will become increasingly important for the Commission and licensees to answer effectively such questions as how much money goes to the charitable purpose, how much money actually goes to direct services to benefit clients, how much it costs to raise that money, and what proportion of the organizations' total revenues and expenses are gambling as opposed to non-gambling.

CHARITABLE AND NONPROFIT GAMBLING IN WASHINGTON STATE FINDINGS AND RECOMMENDATIONS

CHARITABLE/NONPROFIT GAMBLING SECTOR REGULATED BY THE COMMISSION:

The overall charitable/nonprofit gambling sector is declining, while commercial sector gambling is increasing. Within the charitable/nonprofit sector, Bingo has declined the most, punchboards/pulltabs (PB/PT) have fluctuated, and Raffles have steadily increased. Other gambling activities authorized for charitable/nonprofit organizations—amusement games, fund-raising events and social card rooms—contributed very little net income to the sector by CY2003. See Chapter 2 for added detail.

In CY2003, PB/PT generated the most net income (gross receipts minus prizes and expenses) for charitable/nonprofit organizations, followed by Bingo and Raffles. PB/PT had net income of \$8.0 million, Bingo had net income of \$6.7 million, and Raffles had \$3.2 million. Raffle net income is now almost half as much as Bingo net income. See Chapter 2 for more detail.

The efforts of the Commission to assist the largest Bingo licensees to comply with net income/net return/adjusted cash flow rules have not accomplished their goal in terms of the amount of funds required for the stated purposes. While the rule changes (nine since 1983) have enabled most licensees to get or stay in compliance, they have reduced the required income/cash for the stated purpose by 58% since 1990. The rule changes have substantially “lowered the bar,” especially for the largest licensees. See Chapter 6 and Appendix E for more detail.

The Commission did not develop or employ a clear and consistent philosophy or guiding principles within which to make decisions about net income/net return/adjusted cash flow requirements. As a result, the Commission, albeit with the best intentions, responded piecemeal and reactively to licensee concerns about compliance. This in turn led to the unintended but dramatic reduction in the amount of income/cash required for the stated purposes.

RECOMMENDATION: The Commission should develop a clear philosophy and set of principles to guide its regulation of the charitable/nonprofit sector gambling activities and requirements. The philosophy and principles should address increased requirements for income/cash for the stated purposes, whether an organization exists primarily for gambling or other purposes, and how standards from the broader charitable/nonprofit environment might be utilized in the Commission’s regulatory work. See Chapter 4 for a more detailed list of issues to be considered.

RECOMMENDATION: The Commission should clarify which business factors in charitable/nonprofit gambling it can influence through its regulatory program. The conditions that caused the compliance problems for the largest licensees in the first place—larger prize payouts, competition from organizations that the Commission does not regulate, the aging of the customer

base, changing customer preferences—may not be factors that the Commission can influence through its rule-making.

However, if the factors the Commission does control would result in reductions in the amount of cash required for the stated purposes, then the Commission should assess whether this is the intent.

RECOMMENDATION: The Commission should consider increasing the adjusted cash flow requirement to increase the amount of funds required to be applied to the stated purposes. In other states, notably Oregon, Tennessee and Indiana, policy-makers are considering or implementing increases in return requirements. Holding licensees to higher standards, rather than helping licensees stay in compliance, is becoming a higher priority. See Chapter 7, Other States.

The current business model for large-scale C/NP gambling may be failing, given changes in the gambling industry overall. Large C/NP licensees may no longer be able to compete with commercial or tribal gambling operators on type of game, size of prize payout, or related amenities. The competitive advantage for C/NP licensees may increasingly be the “good causes” that their gambling income supports, and players that participate in C/NP gambling may do so in order to support the charitable purpose of the organization.

RECOMMENDATION: The Commission should consider the erosion of the C/NP gambling business model and the implications of this erosion for regulating the C/NP sector, as part of its discussion of philosophy and guiding principles. Successful and unsuccessful C/NP gambling activities should be studied to understand the business dynamics more fully.

RECOMMENDATION: If it is true that the “good cause” focus will increasingly be the competitive advantage for C/NP licensees, then the Commission should study fundraising and financial standards from the charitable/nonprofit environment as possible factors to regulate. See Appendix G for examples and detail.

There are a number of standards in the greater charitable/nonprofit environment that could be beneficial to the Commission in its regulatory role. These include both the legal requirements—501 (c) designation as appropriate and registration in the State of Washington as a corporation and/or a charity as required--as well as voluntary industry standards about cost of fundraising, percent of dollars spent on programs, disclosure of fundraising costs to donors (players), audits, allocation methodologies, etc.

RECOMMENDATION: The Commission should compile relevant charitable/nonprofit standards and utilize them as appropriate in setting regulatory standards for charitable/nonprofit gambling. See Appendix G for examples and detail.

FINANCIAL DATA: The financial findings and recommendations below are based on a sample of 22 sets of qualification review financial reports. The reports contain financial data from nineteen of the largest licensees, from 2002-03. Three licensees had both 2002 and 2003 reports in the sample, for a total of 22 sets of financial reports reviewed. Appendix F contains the detailed analysis and a list of the licensees whose financial reports were reviewed.

A number of the largest licensees from this sample report that gambling expenses are the majority of their total gambling and non-gambling expenses. Over half of the 22 qualification review financial reports showed gambling expenses at 60% or more of the organization's total expenses. This raises the question of the primary purpose of the organization—gambling or programs.

A number of the largest licensees from this sample report that gambling revenues are the majority of their total gambling and non-gambling revenues. Over 40% of the 22 situations reviewed showed gambling revenue as 60% or more of the organization's total revenue. This raises two questions: what is the primary purpose of the organization, and is the organization too vulnerable to further downturns in the charitable/nonprofit gambling sector.

RECOMMENDATION: The Commission should set or seek additional standards, beyond those currently mentioned in statute, for organizations to demonstrate that they are “operating primarily for purposes other than gambling”. Such standards should include both expense and revenue standards and be phased in over time to allow licensees adequate time for compliance. For example, Ohio requires their charitable/nonprofit licensees to have less than 50% of their total (gambling and non-gambling) expenses in gambling expenses.

Sixty-eight percent of the largest licensees reviewed in this sample showed overall net losses in their total operations (gambling and non-gambling) for the periods reviewed (2002-03). The reported losses ranged from \$613,000 to \$1,900. Five organizations showed net losses of more than \$100,000, and another four had losses between \$50,000 and \$90,000. Losses of this magnitude, even if only for one year, can endanger the ability of the organization to continue as a going concern. See Audit recommendation below.

The financial reports required from and provided by Group IV and V licensees that undergo regular qualification reviews are not required to be drawn from audited figures. Rather, a CPA is required to compile the figures but may do so from unaudited figures from the licensee. This means that internal controls (essential in high-cash operations), methods for allocating expenses to different gambling activities, and other financial factors may not be examined by an outside CPA.

RECOMMENDATION: The Commission should require copies of outside audits for all licensees over \$500,000 in gross receipts. This should include the management letter, which will identify material weaknesses in systems and any auditor comments on whether the organization is a going concern. The \$500,000 figure is a substantially higher threshold than is typically set for nonprofit organizations.

RECOMMENDATION: The Commission should set criteria for appropriate allocation of expenses among gambling activities. This is in response to the wide fluctuation in expenses allocated to PB/PT.

RECOMMENDATION: The Commission should review the expense reporting format for Qualification Review financial data to determine why so many expenses are reported in the “Other” category. Additional categories may need to be added to capture expenses adequately.

DATA MANAGEMENT AND UTILIZATION:

The Commission has an extensive database that is not being used to its fullest capabilities. The Commission has a wealth of information in its database that could assist in monitoring, tracking trends and flagging potential problems. Several types of indicators, based on Commission data, were developed for this project. Utilizing such indicators on a regular basis would assist Commission staff in spotting problems and identifying trends and changes.

RECOMMENDATION: The Commission should investigate ways to incorporate “flags” or indicators into the database as an early warning and diagnostic tool for staff to use. Possible indicators include cost to raise (CTR) a dollar of net income, net income as a percentage of gross receipts, gambling expenses as a percentage of total expenses, and gambling revenues as a percentage of total revenues. See Appendices F and C for examples.

The Commission has no meaningful way in its current database to differentiate between “charitable” and “nonprofit” organizations, or to analyze the various stated purposes. The original distinction, that “charitable” meant providing help and assistance to people and “nonprofit” meant benefiting the club or post, has been lost. Further, because every potential licensee can self-identify multiple stated purposes, the stated purpose information is inconsistent at best. If the Commission wished to look more closely at stated purpose, the current data base would not provide appropriate information to do so. See Chapter 3, Stated Purpose analysis.

RECOMMENDATION: The Commission should consider using the IRS definitions of “charitable” and “nonprofit” and/or the appropriate stated purpose designations approved by the IRS to classify current and future licensees and update the database accordingly. The IRS 501 (c) code (Publication 557) provides the structure for doing this. Texas differentiates only at the “charitable” versus “nonprofit” level; Ohio uses the detailed 501 (c) categories. Either is preferable to the current system.

LEGISLATIVE:

The political/legislative history and declarations related to gambling show clearly that the Legislature intended to authorize both charitable/nonprofit and commercial gambling. However, there is no language that indicates that the Legislature intended to favor or encourage charitable/nonprofit gambling over other forms of gambling. See Appendices A and B for further detail on the legislative/political history and legislative declarations.

OTHER:

The rules applying to charitable/nonprofit organizations are spread throughout the various WAC chapters. A potential licensee, seeking to understand the operational or financial requirements of operating gambling activities, would have to refer to five different chapters to identify all of the requirements.

RECOMMENDATION: The Commission should consider compiling the relevant rules for each charitable/nonprofit gambling activity, including the general rules for charitable/nonprofit organizations, into individual documents. To save on printing costs, this material could be made available on CD rather than hard copy.

CHARITABLE AND NONPROFIT GAMBLING IN WASHINGTON STATE PROJECT OVERVIEW AND ACKNOWLEDGEMENTS

This research project was done at the request of the Washington State Gambling Commission, to obtain factual and unbiased independent factual data concerning charitable/nonprofit (C/NP) gambling, reach conclusions, and make recommendations for changes.

The RFP for the project identified the following scope of work:

Review and summarize the legislative history from when the Gambling Act was passed in 1973, including reviewing news articles during that period. Determine if other versions of the legislative declaration (RCW 9.46.010) were considered and whether there have been any court decisions that refer to, or interpret, the legislative declaration. As part of the review of the legislative history, determine if charitable/nonprofit organizations were discussed when the legislative declaration was being developed. Report the reasons for passage of the Act, focusing on both the history of corruption/graft that had occurred and reasons charitable/nonprofit gambling was allowed. Examine the statutory structure that exists to implement charitable and non-profit gambling to determine if the current laws and changes made to the gambling act since 1973 promote the legislative declaration (the policy of the state) of allowing charitable/nonprofit organizations to raise funds through gambling (example: the recent change removing the restriction on operating 3 days/week). Staff will provide some background information for this.

Review the Commission's rules and regulatory program for charitable/nonprofit gambling and draw conclusions as to whether these are consistent with the legislative declaration and intent, and statutes as identified by the research. If not, make recommendations for changes. Include in this a review of the current adjusted cash flow rules and determine whether implementation of these rules has been successful in ensuring funds are directed towards the stated purposes of the charitable/nonprofit organizations. If not, make recommendations for changes. Many rules were passed when bingo was a primary gambling activity; since that has changed, make recommendations on whether rules should or could be changed, yet still be consistent with the legislative intent.

With the assistance of staff and/or information provided by Commission staff, collect and summarize factual data, showing how bingo and other charitable/nonprofit gambling activities (punchboards/pull tabs, raffles, amusement games, and social card rooms) are occurring today. Based on a representative sample, compare the differences between large, medium, and small operators. In this, compare payout percentages, net income, volunteers versus paid positions, and other costs for the three groups. Determine how many organizations have "charitable" purposes compared to "non-profit" purposes.

Based on a representative sample, determine what percent of organizations' budgets are from gambling revenue compared to other sources of revenue and compare how this has changed over the past five, ten and twenty years. Determine if the percent varies based on the type of gambling activities the organization offers (raffles only, bingo, etc.). Determine what services are currently funded through gambling dollars. Determine what other sources of revenue are available for charitable/nonprofit organizations.

With the assistance of staff and/or information provided by Commission staff, create a timeline showing gross receipts, number of licensees, and when charitable/nonprofit and other changes were made.

By contacting states that have significant amounts of charitable/nonprofit gambling, determine if there are ways to enhance Washington's regulation of the charitable/nonprofit industry. Also determine what games or gambling activities have been added in other states or Canada in the past ten years for charitable/nonprofit gambling. For each game or activity, determine whether they have been successful and identify the necessary statute or rule changes needed and policy implications.

The project included in-depth research on the history of gambling, including C/NP gambling in the State of Washington, from Territorial days through 1973, when the initial authorizing legislation was passed. Five legislative declarations are examined in detail. The project included detailed timelines of regulatory and legislative changes since 1973 for the three largest C/NP gambling activities: Bingo, Punchboards/Pulltabs (PB/PT) and Raffles.

The project included a large data analysis component, based on information from the Commission's extensive database. Data analysis was performed based on size of licensee, the largest licensees in each activity, and stated purpose. Organizational financial data were also reviewed for a sample (22) of the largest licensees, based on qualification review financial data.

Finally, the project included conversations with state officials in Oregon, Ohio, Michigan, Minnesota, Texas and California regarding regulation of their charitable/nonprofit gambling sectors.

I would like to extend my deepest appreciation to the many talented and dedicated Commission employees who assisted with this project:

- Amy Blume, the project coordinator, who answered innumerable questions, connected me with many staff members, provided materials and spoke with me regularly to help keep the project on time and focused;
- Susan Arland and Arlene Dennistoun, who provided detailed information about legislation and WAC's;
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- Terry Westhoff, Tina Griffin and Dave Trujillo, who provided information about qualification reviews and licensing requirements;
- Neal Nunamaker, who provided an invaluable historical perspective.

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Sally Perkins
Practical Solutions
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